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IN THE

Supreme Court of the United States

GENERAL ELECTRIC CO.,
Petitioner,

v.

LISA PEREZ JACKSON, ADMINISTRATOR, UNITED STATES ENVIRONMENTAL PROTECTION AGENCY, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF OF FINANCE PROFESSORS AND SCHOLARS AS *AMICI CURIAE*

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BRIEF OF FINANCE PROFESSORS AND SCHOLARS AS *AMICI CURIAE*

STATEMENT OF INTEREST[1]

Amici curiae are finance professors and scholars who teach and write on corporate finance and financial economics. *See* Appendix of *Amici Curiae*. *Amici*'s academic work has included a focus on the

[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no party or counsel for a party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici curiae* or their counsel made a monetary contribution to the preparation or submission of this brief. Counsel of record for all parties received notice at least ten days prior to the due date of *amici curiae*'s intention to file this brief.

real effects of financial constraints—*i.e.*, limitations on the availability of credit or increases in the cost of financing—on firms' behavior and policies. *Amici* Professors Campello, Graham, and Harvey, for instance, recently published an article in the Journal of Financial Economics addressing the real business effects of financial constraints on firms during the recent global credit crisis. *See* Murillo Campello, John R. Graham & Campbell R. Harvey, *The Real Effects of Financial Constraints: Evidence from a Financial Crisis*, 97 J. Fin. Econ. 470, 471 (2010). Their research bears directly on the issues in this case. *See* Pet. 27-28.

Based on their expertise, *amici* are well positioned to explain the real effects of financial constraints suffered by firms as a result of action—including unilateral government action—that limits the availability and increases the cost of financing. *Amici* believe that a more fulsome understanding of the business ramifications of such constraints will aid the Court's assessment of the issues in this case.

SUMMARY OF ARGUMENT

From the Great Depression to the recent financial crisis, this Nation has recognized that credit is the "lifeblood" of business, of jobs, and of our economy. *See* President Barack Obama, Address to Joint Session of Congress (Feb. 24, 2009) ("the flow of credit is the lifeblood of our economy"); President Herbert Hoover, Address at Des Moines, Iowa (Oct. 4, 1932), *in The Public Papers of the Presidents of the United States: Herbert Hoover, 1932–1933* 467 (1977) ("credit is the lifeblood of business, the lifeblood of prices and jobs"). In order to operate—that is, to acquire, use, and dispose of the things that companies own—companies need access to credit.

We understand the D.C. Circuit in this case held that U.S. companies have no protected interest under the Due Process Clause in "the market's assessment of their . . . credit worthiness"—*i.e.*, their credit ratings. Pet. App. 13a. The creditworthiness of firms and whether firms have access to credit markets based on their credit ratings is a question of significant national importance. Research shows that U.S. firms that faced financial constraints—*i.e.*, limitations on the availability or increases in the cost of financing—during the recent credit crisis experienced sharp declines in all areas of their business. Pet. 27-28 (citing Murillo Campello, John R. Graham & Campbell R. Harvey, *The Real Effects of Financial Constraints: Evidence from a Financial Crisis*, 97 J. Fin. Econ. 470, 471 (2010)).

Amici, who have studied and taught these issues for years, submit this brief to further explain the recent literature and real-world effects of such constraints, including those caused by credit rating downgrades. *Amici*'s work and the leading research in this area reflect that credit rating downgrades may impose a financial constraint on firms by raising their cost of borrowing and limiting their access to credit. Even a modest decrease in a firm's credit rating can dramatically increase the interest rate that the firm must pay to obtain credit and a downgrade has attendant consequences for a company, its stockholders, and its employees. Firms facing financial constraints often must shed employees; cut spending on technology, marketing, and investment; burn through cash reserves; and forgo or decrease dividend payments. Constrained firms' future investment opportunities are distorted, and financial constraints may even lead to firm failure.

In evaluating the D.C. Circuit's view that such interests are not afforded due process protection, we believe *amici*'s perspective highlighting the real effects of financial constraints on firms and the vast national importance of these issues may be of assistance to the Court.

ARGUMENT

THE AVAILABILITY AND COST OF CREDIT ARE CRITICAL TO FIRMS' ABILITY TO OPERATE

A. Credit Rating Downgrades Limit the Availability of Credit and Increase its Cost to Firms

Credit rating agencies, such as Standard & Poor's, Moody's, and Fitch, provide evaluations of the creditworthiness of firms both generally and with regard to specific debt securities, such as bond issuances. *See* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 Colum. Bus. L. Rev. 109, 114-15 (2009). These ratings facilitate outside investment in firms by providing a third party assessment of a firm's credit risk. *See* Erin M. Wessendorf, *Regulating the Credit Rating Agencies*, 3 Entrepreneurial Bus. L.J. 155, 156 (2008). Corporate executives also rely heavily on credit ratings to determine the appropriate amount of debt for their firms. *See* John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 J. Fin. Econ. 187, Table 6 (2001) (57% of chief financial officers ("CFOs") in a survey reported that credit ratings were "important" or "very important" to their assessment of how much debt to issue).

Even a modest change in a firm's credit rating can have measurable effects on the availability and cost of credit, as shown by recent studies of the 1982 Moody's credit rating refinement. *See, e.g.*, Tony T Tang, *Information Asymmetry and Firms' Credit Market Access: Evidence from Moody's Credit Rating Format Refinement*, 93 J. Fin. Econ. 325, 350 (2009) (examining the impact of Moody's credit rating refinement on corporate financing policies and real outcomes); Doron Kliger & Oded Sarig, *The Information Value of Bond Ratings*, 55 J. Fin 2879, 2881 (2000) (finding that the refinement had substantial effects on firms' bond prices and stock values). Before 1982, Moody's reported firms' creditworthiness using nine credit rating classes ranging from "Aaa" to "C." Tang, *supra*, at 327. In April 1982, however, without advance public notice, Moody's expanded this system to 19 rating classes by introducing numerical modifiers to the former classes Aa, A, Baa, Ba and B Within those rating classes, Moody's assigned a modifier 1, 2, or 3 to indicate the best, average, and worst credit quality. Importantly, this rating refinement was not related to any changes in firms' underlying risk profiles, but rather was implemented solely to improve information disclosure. The refinement thus provided a unique opportunity to study the impact of changes in credit ratings on the availability and cost of credit *Id.* at 327-38

One leading peer-reviewed article compared the effects of the refinement on firms that experienced a credit rating upgrade (that is, they received a 1 modifier) and those that were downgraded (that is, they received a 3 modifier). *Id.* at 327 The article concluded: "Better ratings allow [firms] to have better capital market access, both in terms of the cost of borrowing and the amount of debt issued." *Id.*

In particular, downgraded firms on average experienced a 15-30 basis point increase in their cost of borrowing relative to upgraded firms. *Id.* at 333. This significant change in firms' borrowing costs illustrates the noticeable consequences of even slight changes in credit ratings.

The Moody's refinement also illustrates the impact of changes to a firm's credit rating on the firm's access to credit markets. In the year following the refinement, downgraded firms issued significantly less debt than upgraded firms, indicating that "firms with better credit quality can now tap into the long-term debt market more easily." *Id.* at 337; *see also id.* at 331, Figure 1.

Another recent study of firm behavior during the 2008 credit crisis further demonstrates the connection between credit ratings and financial constraints. In a survey of CFOs worldwide, only 13% of CFOs from firms rated "investment" grade reported experiencing financial constraints during the 2008 crisis, whereas nearly half of CFOs from firms with "speculative" grade credit ratings reported being constrained. Murillo Campello, John R. Graham, & Campbell R. Harvey, *The Real Effects of Financial Constraints: Evidence from a Financial Crisis*, 97 J. Fin. Econ. 470, 476 (2010).[2]

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[2] According to Standard & Poor's, "investment" grade means a rating of BBB- or above, and "speculative" grade means BB+ or below. *See* Standard & Poor's Credit Ratings Definitions & FAQs, *available at* http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us.

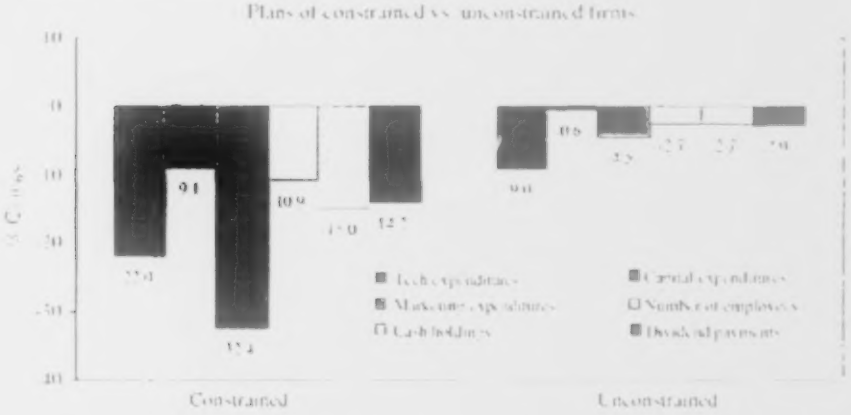
B. Financial Constraints Have Significant Adverse Effects on Firms' Behavior and Performance

Evidence from the recent global credit crisis powerfully illustrates the real effects of constraints upon the availability or cost of financing to firms. While the downturn provided a unique opportunity to study the impact of financial constraints on firms, the research findings also apply in other settings.

In a comprehensive study, Campello, Graham, and Harvey (2010) analyzed the results from a survey of 1,050 chief financial officers ("CFOs") in 39 countries in North America, Europe, and Asia in December 2008. *See* Campello et al., *supra*, at 470. The survey asked CFOs whether and to what extent their firms faced financial constraints—*i.e.*, limitations on the availability or increases in the cost of financing—during the crisis, and about the effects of those constraints on their firms' behavior. The survey results showed that during the crisis roughly one in five U.S. firms was substantially more constrained ("constrained firms") than others ("unconstrained firms"). *Id.* at 476. Constrained firms experienced various forms of constraint, including limited availability of credit (reported by 81% of CFOs at constrained firms), higher borrowing costs (reported by 59% of CFOs at constrained firms), and difficulties in originating or renewing a bank line of credit (reported by 55% of CFOs at constrained firms). *Id.* at 477. Unconstrained firms reported experiencing such constraints at substantially lower rates. *Id.*

The real effects of financial constraints during the crisis were dramatic: constrained firms suffered substantially greater reductions than unconstrained firms with regard to virtually every key business metric. *Id.* at 478.

As the following chart illustrates, on average constrained firms in the U.S. planned in 2009 to dramatically reduce employment (by 11%), technology spending (by 22%), capital investment (by 9%), marketing expenditures (by 32%), cash holdings (by 15%), and dividend payments (by 14%), whereas unconstrained firms planned, on average, significantly smaller cuts in each area:



Id. at 478, Figure 2; *see also* Tang, *supra*, at 332, Figure 2 (finding in the context of Moody's rating refinement that downgraded firms experienced substantial reductions in capital expenditures relative to upgraded firms). These reductions negatively affect the health and strength of constrained firms, with attendant consequences for employees and the economy at large.

Planned workforce reductions of nearly 11% by constrained firms have broader implications for the national economy, not least because, "in the context

of the current crisis . . . cuts in corporate sector employmer have contributed to further declines in residentia value and investment, which are at the root of the crisis." Campello et al., *supra*, at 471.

Further, the substantial reduction in capital expenditures by constrained firms during the crisis also is significant. More than half of CFOs at constrained firms reported a propensity to cancel investments in response to limits on access to external financing compared with 31% of unconstrained CFOs. *Id.* at 485. Firms with greater financial flexibility are more able to avoid financial distress in the face of negative shocks, and are more able to fund investment when profitable opportunities arise. *See* Andrea Gamba & Alexander Triantis, *The Value of Financial Flexibility*, 63 J. Fin. 2263, 2263 (2008) In contrast, when firms cannot absorb negative shocks and forgo or cancel planned investment opportunities, they reduce their prospects for growth. Indeed, it is widely recognized that "investment is necessary for growth." Emanuel Thornton Weiler, *The Economic System: An Analysis of the Flow of Economic Life* 693 (1952). That constrained firms burn through their cash holdings at much higher rates than unconstrained firms further diminishes their capacity for investment, because "firms with more cash on hand invest more." Jeremy C. Stein, *Agency, Information and Corporate Investment*, *in Handbook of the Economics of Finance* 111, 127 (2003).

At bottom, research shows that financial constraints—*i.e.*, limitations on the availability or increases in the cost of financing—are associated with underperformance by the constrained firm. In 2008, constrained firms reported profits at a substantially lower rate than unconstrained firms. *See* Campello

et al., *supra*, at 476, Table 3. Constrained firms also expected to grow at a slower pace than unconstrained firms; 67% of constrained firms reported expected growth exceeding 5% in 2009, whereas 78% of unconstrained firms expected to exceed that benchmark. *Id.* at 476.

Finally, financial constraints also are associated with firm failure. One recent study examined the impact of financial constraints on firms' failure rates in Europe, concluding that "financial constraints play a significant role in determining the probability of firm survival." Patrick Musso & Stefano Schiavo, *The Impact of Financial Constraints on Firm Survival and Growth*, 18 J. Evol. Econ. 135, 147 (2008).

* * *

In evaluating the D.C. Circuit's decision as it relates to a company's interest in "the market's assessment of [its] . . . credit worthiness," Pet. App. 13a, *amici* believe that recent research reflecting the real effects of financial constraints bears on the nature of the interest at stake and the importance of these issues. In order to operate—that is, to acquire, use and dispose of the things that firms own—firms need access to credit. Significant limitations on the availability of credit or increases in the cost of financing cause firms to suffer significant adverse real-world consequences. Constrained firms do not hire, spend, invest, or grow as they otherwise would.

CONCLUSION

For the foregoing reasons, *amici* respectfully submit that these issues are of national importance and merit the Court's consideration.

Respectfully submitted,

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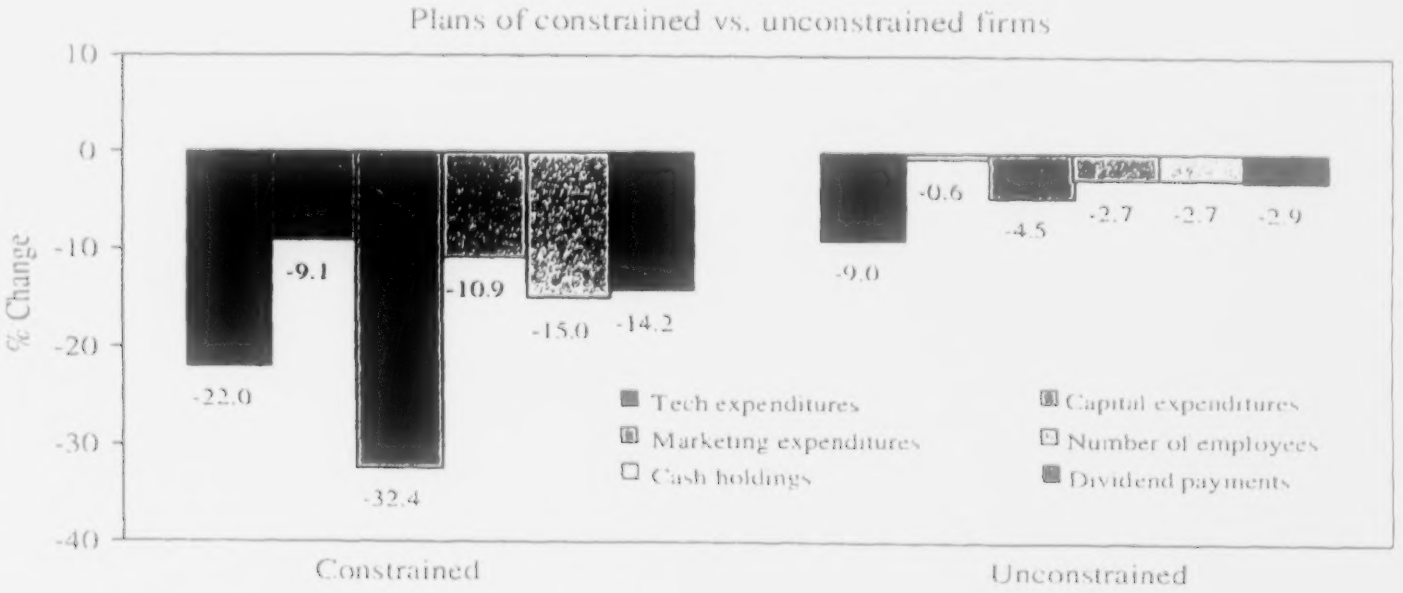

APPENDIX

APPENDIX OF *AMICI CURIAE*[1]

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